Repos: the missing piece in financial market reform

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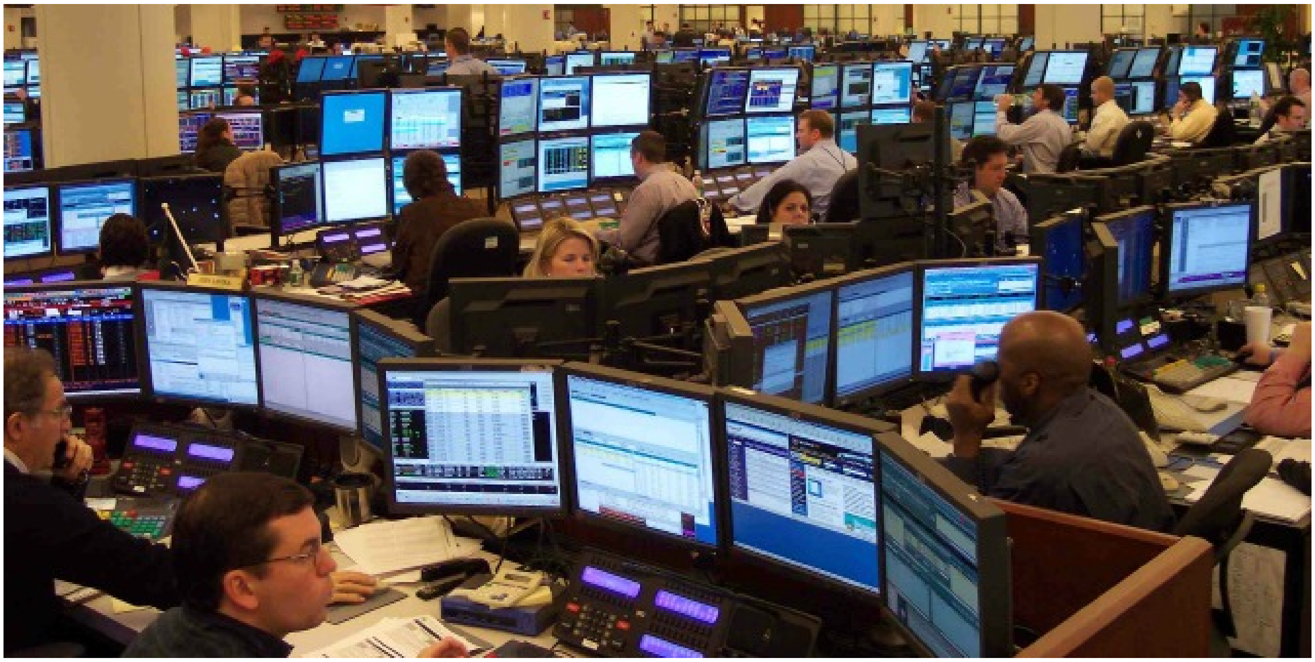

We all remember the hectic summer and fall of 2008 when the financial system was at the brink of the collapse. Since that time, policymakers have enacted structural reforms to the financial system, but what about the repurchase agreements (repo) market?

A repo is the sale of financial assets coupled with a promise to repurchase the same assets at a later date. With similar economic characteristics to secured loans and bank deposits, repos are one of the main sources of liquidity for the financial system. Having developed free from the watchful eyes of regulators, the repo market has flourished by “arbitraging” the regulatory framework.

During the 2007-2008 financial crisis, however, the engine of the repo market halted. This triggered a severe liquidity crunch and financial institutions such as Lehman Brothers and Bear Stearns were brought to the brink of ruin because of their overreliance on repo financing. In the post-crisis regulatory agenda, however, the repo market was left at the periphery of the discussion. The Dodd-Frank Act, for example, though depicted as the reform to create a safer financial system, essentially left this important source of systemic risk untouched.

In my paper, I identify three weaknesses of the repo market that led to market failures: opacity, conflicts of interest, and systemic risk. The article challenges the current passive regulatory approach to the repo market and proposes a two-step policy reform built upon financial market infrastructure. First, the paper argues for greater transparency via trade repositories. Second, to reduce conflicts of interests and mitigate systemic risk, the paper calls for the repo market to use trading venues and central clearinghouses.

The American repo market had developed into two main segments: bilateral and tri-party. In the former, parties mutually agree on the terms and the performance of the contract. In the latter, the parties set up a multi-party deal, where a clearing bank, acting as an agent, offers ancillary services in the management and transfer of the cash and the collateral. (For the sake of completeness, a third small segment of repo transactions on fixed-income assets are centrally cleared by the Fixed Income Clearing Corporation.)

This article unpacks the three main failures in the repo market unfolded by the financial crisis:

1. a) Opacity: From a macro-prudential perspective, opacity limits the capacity of regulators to oversee the market, to assess its riskiness, and to effectively intervene in the event of a crisis. From a micro-prudential angle, the lack of readily available and comprehensive information on market participants, trades, and collateral used, reduces market efficiency by making risk-pricing more expensive and potentially inaccurate.
2. b) Conflicts of interest: The repo market is a concentrated close market with high reputational entry costs and built around the operations of few dealers and the two clearing banks.
3. c) Systemic risk: The repo market is a potential source of systemic risk because of its being a crucial source of liquidity for financial system; and because of the lack of any stability buffer or safety net.

So, is there a case to regulate the repo market? YES. The New York Federal Reserve took initiatives to reform some aspects of the tri-party repo market business, but further steps have to be taken, and financial market infrastructure are – in my opinion – the mechanisms that can render the repo market more efficient and stable.

First step: Mandating reporting of all repo transactions to trade repositories can foster transparency – this is the Financial Stability Board's approach.

Second step: Moving repo trading on multilateral venues and having repos cleared through clearinghouses can reduce conflicts of interests and produce efficiencies and stability. Trading venues offer stable, non-discretionary and multilateral platforms to trade repos. This will increase competition, reduce reputational entry and stay costs, and foster pre and post trade transparency. Clearinghouses, then, by operating as central counterparties, act as private stability buffers, mitigating systemic and liquidity risk, providing mutual loss absorbing mechanisms, and eradicating the conflicts of interest in the tri-party clearing market.

Briefly concluding, my article analyses a crucial segment of the financial system which, despite having played a role in the financial crisis, lives in a regulatory void. I argue that a structural reform is needed to fix the failure of the repo market, and financial market infrastructure can be the fixer for this crucial source of liquidity of the financial system.

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Notes:

- *This post is based on 'The Liquidity Dilemma and the Repo Market: A Two-Step Policy Option to Address the Regulatory Void', forthcoming in the Stanford Journal of Law, Business & Finance, and available as an LSE Law Society and Economy Working Paper, WPS 21-2015*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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Paolo Saguato is a LSE Fellow in Financial Regulation. He joined LSE after a year as a Global Hauser Fellow at New York University School of Law where he was affiliated with the Center for Financial Institutions and conducted research on the repurchase agreement market. Paolo holds a LL.M. degree from Yale Law School – where he was a Fulbright Scholar and a Senior Editor of the Yale Journal of Regulation – and a Ph.D. in 'Private, Business, and International Law' from the University of Genoa. His research interests broadly span financial law and regulation as well as banking law and regulation. More specifically, his research examines the dynamics of financial systems and global financial regulation, the role of financial innovation and financial market infrastructure, and the intersections between private and public regulation of financial markets.